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In the Supreme Court of the United States

OCTOBER TERM, 1977

IN THE MATTER OF GOLDEN ENTERPRISES, INC., BANKRUPT, WILLIAM E. BUTNER, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinions of the bankruptcy court (Pet. App. 2a-20a) and the district court (Pet. App. 21a-30a) are unreported. The opinion of the court of appeals (Pet. App. 31a-42a) is reported at 566 F. 2d 1207.

JURISDICTION

The judgment of the court of appeals was entered on December 8, 1977 (Pet. App. 31a) and a petition for rehearing was denied on January 6, 1978 (Pet. App. 43a). The petition for a writ of certiorari was filed on April 4, 1978. The jurisdiction of this Court is invoked under 11 U.S.C. 47(c) and 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the mortgagee of real property is entitled to rents accruing during the period from the initiation of liquidation proceedings to the foreclosure sale of such property, where the mortgage does not provide for an assignment of the rents, the mortgagee does not seek to have the rents sequestered for his benefit, and the mortgagee has no equitable basis for his claim.

STATEMENT

On May 4, 1973, Golden Enterprises, Inc. (Golden) filed a petition in bankruptcy for an arrangement under Chapter XI of the Bankruptcy Act, as added, Sections 301-399, 52 Stat. 905, and amended (11 U.S.C. 701-799). Golden owned several parcels of income-producing real estate located in North Carolina. These parcels were subject to several first mortgages held by various financial institutions and a second mortgage held by petitioner William E. Butner and others in the amount of $360,000. The second mortgage did not provide for any security interest in, or an assignment of, the rents in event of default. During the arrangement proceedings, an agent was appointed to collect the rents and to apply them to the payment of taxes, insurance and amounts due on the mortgages (Pet. App. 2a, 11a-12a, R. 394-395).[1]

Golden operated as a debtor-in-possession but the plan for an arrangement was never confirmed. On February 14, 1975, the arrangement was converted into a liquidating bankruptcy and a trustee was appointed. Petitioner thereafter acquired all of the interests in the second mortgage. During the ensuing liquidating bankruptcy, the trustee collected the rents but by

[1]"R." refers to the separately bound appendix filed with the court of appeals.

instruction of the bankruptcy court made no payments to petitioner. Petitioner took no steps to appeal these instructions or otherwise move to have the rents sequestered for his benefit, although the mortgage was in default. At the initial meeting of creditors, petitioner requested that the property be abandoned to him, subject to the first mortgages. While not directly opposing the abandonment, the trustee suggested a foreclosure sale of the property. The district court accepted the trustee's suggestion and the real estate, subject to the first mortgages, was sold. Petitioner bid in the property for $174,000 and paid for it by applying part of the debt due him, leaving a balance of $186,000 due on his mortgage note.[2] The deed from the trustee specifically provided that "[t]he accrued rents * * * from [the subject property] are hereby expressly not conveyed, but are reserved to the [trustee]" (Pet. App. 33a). Petitioner accepted the deed (Pet. App. 32a-33a). In an uncontradicted affidavit, the trustee alleged that, while the face amount of petitioner's mortgage was $360,000, his investment was $272,200 and that the value of the property he received in the sale was substantially greater than the $174,000 bid price (R. 365-367).

From the inception of the liquidation proceedings until the foreclosure sale, the trustee collected the rents from the property. After the payment of certain uncontested expenses, the trustee had a fund of $162,971 (Pet. App. 32a). At the final meeting of creditors, petitioner claimed the fund remaining in the hands of the trustee on the basis of the $360,000 second mortgage note. The bankruptcy judge noted that petitioner had been allowed

[2]There were actually two sales of the property. At the first sale, petitioner was not allowed to bid the property in on his mortgage debt. On petitioner's appeal, the district court vacated the confirmation of the sale and ordered the property resold (Pet. App. 22a, 33a).

to bid in the property for $174,000 and that "none of the funds in the hands of the Trustee were derived from the sale of the collateral." He therefore held that "the balance of this claim is disallowed as a secured claim" (Pet. App. 16a-17a). However, the bankruptcy judge accorded unsecured claim status to the $186,000 difference between the mortgage note ($360,000) and the bid price (Pet. App. 17a). The bankruptcy judge also allowed certain uncontested fees and expenses of administration to be paid out of the fund. The balance of the fund was determined to be available for distribution for debts and expenses under Section 64 of the Bankruptcy Act (11 U.S.C. 104)[3] (Pet. App. 17a-19a).

The district court reversed the order of the bankruptcy judge and found that petitioner's "secured status extended to the rents and profits derived from the property during the administration of the bankrupt's estate" (Pet. App. 29a). The court of appeals reversed and remanded the case for reinstatement of the bankruptcy judge's order. In its view, petitioner was not entitled to the rents that accrued during the bankruptcy proceeding because he did not request the bankruptcy court to sequester the rents for his benefit or to appoint a receiver on his behalf (Pet. App. 36a-37a).

ARGUMENT

1. The court of appeals correctly concluded that petitioner, a second mortgagee of real property, was not entitled to the rents arising from the property during the period from the initiation of liquidation proceedings to the foreclosure sale of the property.

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[3]The government filed its proof of claim as a creditor for unpaid federal taxes of approximately $50,000 (Pet. App. 34a).

As the court properly observed (Pet. App. 34a-35a), the question of a secured creditor's right to income, generated by the secured property during bankruptcy, has produced a conflict in the circuits. However, as the discussion that follows demonstrates, this case is an inappropriate vehicle for the resolution of the conflict because petitioner cannot prevail under either line of authority.

a. In accord with the decision below, the Second, Eighth and Ninth Circuits have held that the mortgagee has no right to the rents once the bankruptcy court assumes control of the property, unless he petitions the bankruptcy judge for a sequestration order, obtains the appointment of a receiver to collect the rents, or secures the bankruptcy judge's consent to foreclose. See *In re Brose*, 254 Fed. 664 (C.A. 2); *Tower Grove Bank & Trust Co.* v. *Weinstein*, 119 F. 2d 120 (C.A. 8); *In re Hotel St. James Co.*, 65 F. 2d 82 (C.A. 9). See also *Fidelity Bankers Life Insurance* v. *Williams*, 506 F. 2d 1242, 1243 (C.A. 4). This approach generally follows state law in determining the entitlement of a mortgagee to rents. For example, where, as here, the law of the state in which the property is located (North Carolina) provides that the mortgagee is not entitled to the rents until he either takes possession of the property or has a receiver appointed to collect the rents for his benefit.[4] These circuits require that the mortgagee take affirmative action to cause the rents to be sequestered for his benefit. See 4A *Collier on Bankruptcy* §70.16 (14th ed. 1976). Under the view of the Second, Eighth, and Ninth Circuits, and the court below, the primary focus is on the nature of the mortgagee's interest in rents under state law, the terms of the mortgage and the acts of the parties. See 4A *Collier, supra*. See also *Freedman's Savings Co.* v. *Shepherd*, 127 U.S. 494, 502.

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[4]See *Gregg* v. *Williamson*, 246 N.C. 356, 98 S.E. 2d 481; *Kistler* v. *Development Co.*, 205 N.C. 755, 172 S.E. 2d 413.

b. The contrary line of authority is in the Third and Seventh Circuits. See *In re Pittsburgh-Duquesne Development Co.*, 482 F. 2d 243 (C.A. 3); *In re Wakey*, 50 F. 2d 869 (C.A. 7). Those courts have held that the mortgagee may recover the rents if he can establish an equitable basis for his claim. The rationale for these decisions is that the rights of the creditors are fixed at the adjudication of bankruptcy and the bankruptcy divests the mortgagor's possession of the realty. Therefore, the rents arising thereafter belong to the mortgagee and should not be diverted to general creditors. See 4A *Collier, supra*, at §70.16. Under these decisions, however, the mortgagee cannot recover the rents arising during bankruptcy unless he establishes that "the mortgaged property was worth less than the mortgage indebtedness." *In re Cigar Stores Realty Holdings*, 69 F. 2d 823, 824 (C.A. 2). In those circumstances, the Third and Seventh Circuits regard the rents as belonging to the mortgagee as a matter of equity as part of the agreed security "to vindicate its own right of property." *In re Pittsburgh-Duquesne Development Co., supra*, 482 F. 2d at 246.

2. Petitioner argues (Pet. 11-15) that this Court should resolve the conflict of decisions as to the extent of a mortgagee's rights to rents arising during the bankruptcy of the owner of real property. But petitioner would not be entitled to the rents under either the decisions followed by the court below or the rule of the Third and Seventh Circuits.

a. Under the former line of authority, the mortgagee is entitled to the rents only if he seeks to have them sequestered for his benefit so as to establish possession under state law.[5] Petitioner concedes (see Pet. 17-18)

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[5]Petitioner suggests (Pet. 11-13) that reference to state law in determining his claim to the rents as a secured creditor violates Article I, Section 8 of the Constitution, which provides that "[t]he Congress shall have Power * * * To establish * * * uniform Laws on the subject of Bankruptcies throughout the United States." In his view, the decision below violates this uniformity requirement because "the anomalies contained in the property law of the individual states should not be allowed to create differences in application of the bankruptcy laws" (Pet. 12). But it has long been recognized that reference to state law under the bankruptcy laws is not only appropriate, but required. See *Stellwagen* v. *Clum*, 245 U.S. 605, 613; *Thompson* v. *Magnolia Co.*, 309 U.S. 478, 483-484.

that his interest in the rents did not have a secured status under state law. He nevertheless contends (Pet. 16-21) that he took the necessary action in the bankruptcy court to ensure that the rents would be sequestered for his benefit. But the court of appeals correctly concluded that petitioner did not take necessary action to ensure that the rents be sequestered for his benefit (Pet. App. 37a). While a receiver was appointed to collect the rents during the Chapter XI proceeding, petitioner himself recognizes (Pet. 8) that they were not held specifically for his benefit as additional security for his debt. Indeed, after the arrangement was converted into a liquidating bankruptcy, the bankruptcy judge specifically ordered the trustee not to pay any rents to the mortgagees (Pet. App. 32a). Petitioner did not appeal or even protest this order.

Nor do petitioner's actions taken during the liquidating bankruptcy provide any basis for concluding that the rents were collected for his benefit. As the court of appeals stated (Pet. App. 37a):

> He [petitioner] had * * * made several informal requests that the property be abandoned, but when they were not granted he pursued the matter no further. Indeed, he made such a request of the bankruptcy judge at a time after the adjudication,

> when approximately $50,000 in rents had been collected by the trustee; but at that time he stated [that] he would waive any claim to the accrued rents. When the trustee formally requested authority to sell the property, * * * [Petitioner] was made an adversary party to the request. He filed no answer, although he could have requested abandonment, permission for him to foreclose under state law, or a determination of the priority of his lien on the rents.

Moreover, after the sale, petitioner accepted the trustee's deed which specifically reserved the rents to the trustee (Pet. App. 33a). As we have pointed out (*supra*, p. 3), petitioner did not assert a security interest in the rents until the final meeting of creditors. Thus, petitioner cannot be deemed to have taken any timely action to ensure that the rents would be held for his benefit[6] under the line of authorities followed by the decision below.

b. Nor can petitioner prevail under the rule of the Third and Seventh Circuits. As we have noted (p. 6, *supra*), those courts employ equitable considerations in determining a mortgagee's entitlement to rents accruing during bankruptcy. Here, however, there are no special equities in favor of petitioner's claim. While the district court stated (Pet. App. 28a) that it found "no difficulty in determining that equity requires that rents collected"

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[6]Petitioner argues (Pet. 19) that the decision of the court of appeals was based on the fact that his acts "were not performed 'during bankruptcy' " and that the court did not consider the events which took place in the Chapter XI proceedings (see Pet. 23-24). But it is clear that the court considered all of petitioner's actions both before and after the proceedings were converted into a liquidating bankruptcy. Of primary importance, however, was the fact that the bankruptcy court rescinded its Chapter XI order, and specifically ordered the trustee not to pay the rents of the mortgagee (Pet. App. 36a). Petitioner made no objection to this order.

belonged to petitioner, the court of appeals properly observed that (Pet. App. 37a) "the district court failed to articulate the equitable considerations that it thought required the result that it reached." Indeed, petitioner made no showing that the rents were necessary to make him whole. While petitioner bid in the property for less than the amount of his $360,000 mortgage note, the record also indicates that the property was worth substantially more than the bid-in price indicated and that petitioner "profited from [the] ultimate disposition of the property" (Pet. App. 37a).[7] Compare *In re Cigar Stores Realty Holdings, supra*. In these circumstances, the court of appeals correctly concluded (Pet. App. 38a) that even "[i]f equity has a part in the resolution of a question of this type * * * equity does not supply the answer here."

In sum, petitioner is not entitled to the rents accruing during bankruptcy under either the sequestration rule adopted by the decision below or the equity rule

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[7]Petitioner asserts (Pet. 21-23) that he suffered an economic loss of $57,774.55. This analysis is based on the fact that while he sold a portion of the property for a profit of $165,000, he was deprived of interest on his note for ten months.

But petitioner ignores the fact that he received property at least equal to his investment in the note. The record establishes that the deed from the trustee was recorded on November 20, 1975 (R. 310). In an affidavit, filed with the district court, the trustee stated that shortly after the foreclosure sale, petitioner sold portions of the real estate and refinanced other portions. Assuming conservatively that the value of the refinanced real estate was only equal to the refinanced debt, petitioner received approximately $293,000 in cash and retained unencumbered property appraised at $50,000, for a total of $343,000. Moreover, the trustee pointed out that petitioner's investment in the note was $272,200 rather than the face value of $360,000 (R. 365-367). These facts were never contested.

employed by the Third and Seventh Circuits. Accordingly, the facts of this case are not appropriate for the resolution of the conflict between these two lines of decisions.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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